No. 16,268

# In the United States Court of Appeals for the Ninth Circuit

ESTATE OF DELANO T. STARR, Deceased, MARY W. STARR, Executrix, and MARY W. STARR, PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

**On Petition for Review of the Decision of the Tax Court of the United States**

## BRIEF FOR THE RESPONDENT

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No. 16,268

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## BRIEF FOR THE RESPONDENT

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### OPINION BELOW

The opinion of the Tax Court (R. 31-42) is reported at 30 T.C. 856.

### JURISDICTION

This appeal involves individual income tax deficiencies and Section 294(d)(2) additions to tax determined against Delano T. Starr and Mary W. Starr, then his wife, for the calendar years 1951 and 1952. (R. 31, 44.) Notice of the deficiencies was mailed to the taxpayers on June 30, 1955. (R.

6-12.) On August 31, 1955, within the permitted ninety-day period, the taxpayers filed their petition for review with the Tax Court for redetermination of the deficiencies, within the provisions of Section 272 of the Internal Revenue Code of 1939. ( R. 1-23.) Delano T. Starr died after the petition was filed and his widow Mary W. Starr, executrix of his last will and testament was substituted in his stead. (R. 31.) The decision of the Tax Court sustaining the income tax deficiencies for the calendar years 1951 and 1952 was entered on July 7, 1958. (R. 43, 56.) Petition for review by this Court was timely filed on September 19, 1958. (R. 44-48.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

## QUESTION PRESENTED

Under the facts here obtaining did the Tax Court err in holding that a purported five-year "lease" of an installed $4,960 building sprinkler system, calling for the payment of $6,200 in equal annual installments and for annual renewal "rental" payments of $32 to cover an inspection service charge, was, in substance, a sale, with the result that the respective annual "lease" payments of $1,240, made in each of the taxable years, 1951 and 1952, constituted capital expenditures and not deductible rental expenses, within the meaning of Section 23(a)(1)(A) of the Internal Revenue Code of 1939?

## STATUTE INVOLVED

Internal Revenue Code of 1939:

> SEC. 23 [As amended by Sec. 121(a), Revenue Act of 1942 c. 619, 56 Stat. 798]. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—
>
> (1) *Trade or business expenses.*—
>
> (A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.
>
> * * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

## STATEMENT

The pertinent facts, as stipulated (R. 26-27) and found (R. 13-23, 31-32, 33-34) by the Tax Court below, are as follows:

Delano T. Starr and Mary W. Starr were husband and wife during the years involved and resided at 131 East Hillcrest, Monrovia, California. (R. 31.)

For the calendar years 1951 and 1952 Delano T. Starr and Mary W. Starr filed joint income tax re-

turns with the Collector of Internal Revenue at Los Angeles, California. (R. 31.)

The Commissioner determined deficiencies in income tax and additions to tax of Delano T. Starr and Mary W. Starr as follows (R. 31):

| Year | Deficiency | Additions to Tax Sec. 294(d)(2) |
|---|---|---|
| 1951 | $1,939.86 | $831.73 |
| 1952 | 1,155.14 | 429.05 |

Throughout the period here involved Delano owned and operated the Gross Manufacturing Company, a sole proprietorship. Early in 1950 a general manager of the Gross Manufacturing Company suggested to Delano that insurance premiums on the building occupied by the company were quite large and should be reduced. The general manager suggested that some sort of sprinkler system be established in the building. Insurance premiums on the building occupied by the company were estimated to be in excess of $1,000 per year if the building was not protected by a sprinkler system. If the building was protected by a sprinkler system, the insurance premiums per year were estimated to be only $126.29. (R. 31-32.)

On or about April 3, 1950, Delano T. Starr, doing business as Gross Manufacturing Company (hereinafter called the taxpayer), and "Automatic" Sprinklers of the Pacific, Inc. (hereinafter called Automatic), entered into a written agreement which provided for the installation of a sprinkler system. The sprinkler system was installed under and pur-

suant to the written agreement. (R. 32.) This written agreement provided in part as follows (R. 13-23): [1]

LEASE FORM OF CONTRACT

"AUTOMATIC" SPRINKLERS OF THE PACIFIC, INC.
5508 Alhambra Ave.
Los Angeles 32, Calif.

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INDENTURE OF LEASE, Made this 3rd day of April 1950 by and between the "AUTOMATIC" SPRINKLERS OF THE PACIFIC, INC., A corporation of the State of California, with an office at Los Angeles, California, hereinafter called the LESSOR and DELANO T. STARR, DBA GROSS MANUFACTURING COMPANY, having principal office at Monrovia, California, hereinafter called the LESSEE.

WITNESSETH:

That in consideration of the mutual covenants LESSOR and LESSEE hereto agree as follows:

ON THE PART OF LESSOR:

1. To install and lease for and during the term of five years from and after approval a wet pipe system of fire extinguishing apparatus, hereinafter referred to as the "system" in certain buildings all as indicated on the plan and shown in the specifications hereto attached in the property owned and occupied by the LESSEE

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[1] Since there are apparent errors in the lease as set out in the typewritten record, the wording of the lease is taken from the official report of the Tax Court opinion. 30 T.C. 856.

located in Monrovia, California. Legal description of the property is as follows:

* * * *

2. The system to be installed by LESSOR will be in accordance with the provisions and conditions of the specifications attached hereto and made a part hereof consisting of two sheets, with the exceptions noted, if any. All materials will be of standard quality and the work herein specified will be done in a thorough and workmanlike manner under the rules and regulations of NATIONAL FIRE PROTECTION ASSOCIATION and subject to inspection and approval by PACIFIC FIRE RATING BUREAU acting as agent of both LESSOR AND LESSEE.

3. LESSOR shall inspect the system at least one (1) time per year after its completion and approval and LESSOR shall repair or replace at its own expense any part if found to be defective or worn out under ordinary usage, provided LESSEE has used due diligence in maintaining the system in proper working order.

ON THE PART OF LESSEE:

4. LESSEE shall pay to the LESSOR, or its successors or assigns at Los Angeles, California, an aggegate rental of SIX THOUSAND TWO HUNDRED DOLLARS ($6,200.00) during the term of this lease, payable as follows:

One Rental Payment of $1,240.00 payable May 1, 1950.

One Rental Payment of $1,240.00 payable May 1, 1951.

One Rental Payment of $1,240.00 payable May 1, 1952.

One Rental Payment of $1,240.00 payable May 1, 1953.

One Rental Payment of $1,240.00 payable May 1, 1954.

All deferred rentals shall bear interest at the rate of 6% per annum after maturity.

5. LESSEE shall use due diligence in maintaining the system in proper working order and in compliance with Insurance Companies' requirements. Should the system become impared on account of lack of diligence on the part of LESSEE in properly maintaining same, or if changes or extensions to the system should be required by the Insurance Companies' on account of changes in construction of, or extensions to the buildings, or on account of changes in the contents of the buildings, LESSEE shall notify LESSOR thereof in writing, whereupon LESSOR shall make the required changes in the system at the cost and expense of the LESSEE as soon after receipt of such notification as is practicable. The rentals becoming due and payable during the remainder of the term of this lease shall thereupon be increased in the amount sufficient to reimburse LESSOR for the materials furnished and labor performed.

6. The rentals stipulated in this lease are based on the assumption that the work of installing the system shall be done only during regular working hours. If overtime work is requested by the LESSEE, the same shall be paid for by the LESSEE as additional rental at the time the next rental payment or payments become due after the performance of such overtime work.

7. LESSEE will furnish at his own expense, as and where required by the LESSOR, all necessary

space for the storage and handling of materials and proper facilities for the speedy and efficient prosecution of the work, including the services of watchman; also light, heat, local telephone service and (when available) elevator service, and unless expressly excepted, all painting, (both as to labor and materials), and permits as required by LESSOR of the installation of the system, and the sufficiency of all thereof both old and new including the property herein proposed to be equipped, is warranted by LESSEE.

8. LESSEE agrees that, if prior to the completion of the installation, the work be discontinued by reason of strikes, lockouts, action of the elements, or any cause not LESSOR'S Fault, there shall, at LESSOR'S option, be due and payable by LESSEE to LESSOR upon its demand, a sum equal to the full aggregate rentals stipulated herein less an allowance to be made by LESSOR for materials, labor and expense not supplied or incurred.

9. LESSEE will supply at his own expense throughout the term of this lease, all necessary water, steam, heat and power required to keep the system in proper working order, including sufficient heat to prevent freezing and will exercise due care and diligence in protecting the same from impairment, injury or destruction, and will promptly give to LESSOR written notice of any impairment, injury or destruction.

10. LESSEE will also promptly pay when due and payable, all taxes and assessments of every kind levied upon the land, buildings and contents protected by the system and in lieu of additional rent, upon the system itself and will keep the system (and the materials and component parts

thereof during installation) at all times full [sic] insured in satisfactory insurance companies to at least an amount equal to the sum of the total unpaid rentals under paragraph 4 against loss by fire, lightning and wind storm, making "loss, if any, payable to "Automatic" Sprinklers of the Pacific, Inc., or its successors or assigns, as its interest may appear"; and deliver to LESSOR the policies for such insurance. In the event LESSEE fails to maintain insurance and/or to deliver to LESSOR the said policies, LESSOR may so insure the premises, including the system for its own benefit to the amount of its interest at the time, and pay the premiums therefore [sic] and upon payment of such premiums by the LESSOR, the same shall forthwith become due and owing from LESSEE to LESSOR without demand. LESSEE shall bear the risk of loss of said property and system from any cause whatsoever.

11. LESSEE will not alter, remove or dispose of, or permit the use by others of, the system, or any part thereof, without the written permission of LESSOR, and no discontinuance of ownership or operation of the plant or premises by LESSEE shall terminate or affect the liability of LESSEE hereunder.

12. It is hereby expressly understood and agreed that title to the system and all its component parts and materials shall be and remain indefeasably vested in "AUTOMATIC" SPRINKLERS OF THE PACIFIC, INC., its successors or assigns, and said system shall not be or be deemed to be, a part of or incorporated into the real estate or be deemed to be a fixture.

THE LESSOR AND LESSEE MUTUALLY AGREE:

13. The following shall be deemed events of default: Failure of LESSEE to make rental payments or otherwise comply with obligations of this lease; appointment of a receiver for LESSEE'S property or business, adjudication of bankruptcy, assignment for benefit of creditors, seizure of the premises herein described by judicial process; the obtaining of a judgment against LESSEE, or the filing of a lien against LESSEE'S property, if said judgment or lien be not satisfied or discharged within ten (10) days thereafter.

14. Upon the happening of an event of default, LESSOR may in so far as permitted by law, resume possession of the system, which LESSEE agrees to deliver upon demand, and LESSOR or assigns shall have full right to enter any building structure or premises where said system, or any part thereof may be, and remove, control and/or shut the water off the same without resorting to legal process, and at the cost and expense of said LESSEE, the amount whereof as well as reasonable attorney fees and court costs in any litigation arising therein, shall be added to the balance then owing hereunder.

15. Upon the happening of an event of default, or in case the premises herein described are destroyed in whole or in part by fire, all remaining rental payments shall, at the option of LESSOR, immediately become due and payable, anything herein contained to the contrary notwithstanding. In case of fire, however, the total amount owing to LESSOR, less such amount as may be paid by the Insurance Companies direct to the LESSOR, shall be subject to discount from

date of payment of fire loss to the date of scheduled maturity at the rate of six per centum (6%) per annum, and LESSEE may have the same rate of discount for any rentals it may be pleased to make before maturity.

16. All rights and remedies hereunder given to LESSOR are cumulative and not exclusive and its failure to exercise any right or remedy upon default shall not be construed as a waiver of the right to exercise the same upon succeeding default.

17. LESSOR shall not be liable for any work or materials not furnished by it, nor any loss or damage by reason of the care or character of any walls, foundations, or other structures not erected by it, and any loss or damage from any cause not the fault of LESSOR, to materials, tools, equipment, or work, while in or about the premises shall be borne by LESSEE.

18. If, in connection with the performance of this lease, any damage be cause [sic], or any claim be made, for which LESSOR may be liable, written notice with an itemized statement thereof, must be given to LESSOR promptly and in any event, within the (10) ten days, thereafter, otherwise LESSOR is released from liability.

19. All notices shall be in writing, served by registered mail upon the parties hereto respectively at their respective offices as hereinbefore set forth, or as hereafter designated in writing by one to the other.

20. The installation of the required number of Automatic Sprinklers, but no Open Sprinklers, is provided for in the specifications heretofore attached. The price shall not include the installation of extra sprinklers due to changes in

the buildings or contents after the completion of LESSOR'S survey.

21. It is mutually understood and agreed that any work or materials not specifically described herein, together with what specifically the LESSEE is to supply, shall be supplied by lessee at his own expense, as and when required by LESSOR for the prosecution of the work. Upon LESSEE'S failure so to do, LESSOR may, at its option, as LESSEE'S agent, supply the same at market prices, and its expense by reason thereof, as well as those resulting from delay, shall be additional to the aggregate rentals mentioned herein and shall be paid to the LESSOR upon demand.

22. LESSOR shall not be liable for any loss or damage from delay or otherwise, due directly or indirectly, to strikes, lockouts, embargoes, transporation conditions, action of the elements, acts, orders, rulings, or restrictions of the U.S. Government, or of any instrumentality thereof, or to any cause beyond LESSOR'S control.

23. LESSOR shall have and is hereby given the right to assign this lease and the rental installments and the title to the system. In the event of any such assignment, LESSEE, hereby waives any right of set-off, defense, or counter-claim, now or hereafter existing in favor of LESSEE against such assignee, without however, in any wise waiting or releasing his right to assert such claim as against LESSOR.

24. That the only agreements, obligations and covenants binding on the parties hereto are those set forth herein.

25. In the event of [sic] any of the provisions of this instrument shall be void or unenforcible under the laws of any state where its enforce-

ment is sought, then it is agreed that the LESSOR may exercise all rights and remedies which are conferred upon conditional vendors or holders of chattel mortgages by the laws of the state in which its enforcement is sought, LESSOR to have the right to elect which remedy it will pursue.

26. LESSEE represents that the fee simple title to the land and/or buildings described in Paragraph 1 is vested in DELANO T. STARR and WIFE, as joint tenants; that LESSEE'S interest in said land and/or buildings is a fee simple title estate; that there are no encumbrances affecting the title to the said land and/or buildings and/or LESSEE'S interest therein.

This representation of fact is made to secure the execution of this lease.

Before any work is started under this lease, LESSEE agrees to procure the assent in writing of all the holders of said uncumbrances [sic] and of all the holders of interest or estates in said land and/or buildings to the provisions of this lease, provided that title to the system of fire extinguishing apparatus herein described shall remain in LESSOR and that said apparatus shall remain personally and not become a part of the realty during the term of this lease.

LESSEE further agrees that no liens or encumbrances of any sort will be placed upon its interest in the said land and/or buildings nor shall said land and/or buildings be sold without first procuring the assent of such lienor, encumbrances or purchaser to the said provisions of this lease.

27. This lease shall become a binding and obligatory agreement upon execution by LESSEE: provided, however, that it may thereafter, at the

option of the LESSOR, be terminated and cancelled by LESSOR at any time within thirty (30) days after said lease has been received at the Los Angeles, California, office of LESSOR. If so terminated and cancelled, LESSOR shall immediately notify LESSEE.

28. At the termination of the period of this lease, if LESSEE has faithfully performed all of the terms and conditions required of it under this lease, it shall have the privilege of renewing this lease for an additional period of five years at a rental of $32.00 per year. If LESSEE does not elect to renew this lease, then the LESSOR is hereby granted the period of six months in which to remove the system from the premises of the LESSEE.

IN WITNESS WHEREOF, the parties herein have subscribed their respective names in duplicate this 3rd day of April A.D. 1950.

"AUTOMATIC" SPRINKLERS OF THE PACIFIC, INC.

By Carl O. Gustafson
President

DELANO T. STARR DBA GROSS MANUFACTURING COMPANY

ATTEST:

Olive L. Monson
June L. Gustafson
W. M. Anderson

The Commissioner allowed depreciation in the amount of $269.60 for each of the years 1951 and 1952, determined on the basis of a total cost of the sprinkler system of $6,200 prorated over a remain-

ing useful life of 23 years for the building from May 1950, when the system was installed. (R. 33.)

During each of the years 1951 and 1952 the taxpayer paid $1,240 to Automatic pursuant to the contract. (R. 33.)

Automatic installed building sprinkler systems on a cash basis and on an installment basis. The cash price of the sprinkler system of the type installed in the building occupied by the taxpayer's business was $4,960. The price of the same building sprinkler system on an installment contract basis with payments extending over a five-year period was $1,240 per year, or a total of $6,200. The average installment contract entered into by Automatic covered a five-year period, but customers purchasing building sprinkler systems have been allowed as long as 15 years to pay for a sprinkler system under an installment contract. Automatic has sold approximately 1,700 sprinkler systems. (R. 33.)

The agreement between the taxpayer and Automatic was recorded on the books of Automatic as a long-term receivable and the profit therefrom was computed in the same manner as the profit from a sale. Automatic has installed approximately 25 building sprinkler systems under agreements of this type, and these agreements were entered into by Automatic to stimulate sales. Automatic has never removed a sprinkler system installed under one of these agreements. (R. 33-34.)

Sprinkler systems sold for cash are only inspected once by Automatic. Sprinkler systems sold under contracts of the type between Automatic and the taxpayer were inspected at least one time per year

for the first five years after installation. If the contract was renewed for an additional five years, Automatic inspected the sprinkler system during the second five-year period for an additional service charge of $32 per year. The contract between the taxpayer and Automatic has been renewed for an additional five years and Automatic has been making an annual inspection of the sprinkler system installed under that contract. The cost of this annual inspection to Automatic is $64 per year. (R. 34.)

The estimated useful life of the sprinkler system installed in the taxpayer's building is 20 years or more. (R. 34.)

Upon the basis of the foregoing facts the Tax Court held that the $1,240 paid by the taxpayer to Automatic in each of the years 1951 and 1952 were not deductible as rental expenses under Section 23(a)(1)(A) of the 1939 Code, but constituted instead capital expenditures. (R. 36, 42.) In view of this ruling the Tax Court also sustained the respondent's additions to the tax under Section 294(d)(2) of the Code.

## SUMMARY OF ARGUMENT

The taxpayer entered into a contract with Automatic, a sprinkler system manufacturer, whereby the taxpayer purported to "lease" such a system for a five-year period, making annual payments of $1,240, or a total of $6,200, with the privilege of renewal for five years at an annual "rental" of $32 to cover an inspection service charge. By terms, the taxpayer was required to pay all taxes assessed, bear the risk

of loss, and keep the sprinkler insured at all times in at least an amount equal to the sum of the total unpaid rentals. Automatic was accorded all the rights and remedies of a conditional sales vendor or a chattel mortgagee and could assign its title and right to receipt of the installment payments, in which event the taxpayer waived its rights to set-off, defense, or counterclaim, as against Automatic's assignee, retaining such rights, however, against Automatic. The "lease" recited that title was indefeasibly vested in Automatic and no provision was made to grant the "lessee" an option to purchase. The "lease" did provide that if the taxpayer did not elect to "renew" for the additional five-year period, Automatic would have a six month period in which it could remove the system from the taxpayer's premises. In the event that the taxpayer did or did not elect to renew the "lease" and the six month period should expire with Automatic taking no action to remove, no provision was made as to ownership. Apart from the lease terms, the uncontroverted testimony established that Automatic had sold between 1,700 and 1,800 of its sprinkler systems for cash or on an installment sales basis and had installed only 25 systems under the so-called "Lease Form of Contract". The purchase price, for cash, was $4,960 and the installment sales price, on the customary five-year term basis, was $6,200, the aggregate amount of the $1,240 annual "lease" payments here involved. The $32 annual "rental" during the "renewal" term constituted an established service charge, covering Automatic's cost of making an annual inspection of the installed sys-

tem. On its books, Automatic recorded the profit arising on its "leases" in the same manner as that arising on a five-year installment sale, and finance-wise, both types of contract produced identical amounts, on assignment. All of Automatic's "lease" agreements had been "renewed" and no action had ever been taken to remove a sprinkler from a so-called "lessee's" premises.

Under the above-outlined established facts, the Tax Court correctly held that the purported "lease" amounted, in substance, to a sale of the installed system, with the result that the respective annual "lease" payments of $1,240, made in each of the taxable years, 1951 and 1952, constituted capital expenditures and not deductible rental expenses, within the meaning of Section 23(a)(1)(A) of the Internal Revenue Code of 1939. To secure a rental deduction, the statute requires, alternatively, that the taxpayer must either not be taking title to the property *or* acquiring an equity by reason of the payments made. In construing a sale or a lease, the test is not what the parties label the transaction but, instead, what the parties intend as the legal effect to be produced. Here, the facts compellingly show that the taxpayer acquired an equity in the sprinkler system, with the annual installment payments of $1,240 constituting partial payments on the purchase price. The substance of the so-called "lease" was to give the taxpayer the identical equity interest in the system he would have acquired under a five-year installment sales contract, with the $32 annual payments after the completion of the $6,200 payment constituting

merely a service charge covering annual inspection cost. Under these facts, as the Tax Court correctly observed, the so-called renewal payments of $32 were not even a token payment on the purchase price. However, the annual installment payments of $1,240 were substantially greater than either the depreciated or undepreciated value of the sprinkler system, with the aggregate five-year total amount being equal to the established $6,200 installment sales price. In such circumstances, it is well settled that the taxpayer is properly to be regarded as acquiring an equity in the property. Accordingly, the annual payments of $1,240 do not constitute rental expense, within the established meaning of Section 23(a)(1)(A).

## ARGUMENT

**The Tax Court Correctly Held, Under the Facts Here Obtaining, That the Purported Five-Year "Lease" of An Installed $4,960 Building Sprinkler System, Requiring Total Payment of $6,200 In Equal Annual Installments and Providing for Optional "Lease" Renewal at an Annual "Rental" of $32, Covering an Inspection Service Charge, Amounted, In Substance, to a Sale of the Installed System, with the Result that the Respective Annual "Lease" Payments of $1,240, Made In Each of the Taxable Years, 1951 and 1952, Constituted Capital Expenditures and Not Deductible Rental Expense, Within the Meaning of Section 23 (a)(1)(A) of the Internal Revenue Code of 1939**

We submit that the Tax Court correctly held (R. 42), under this record, that the annual "lease" payments of $1,240, made by the taxpayer during the taxable years, 1951 and 1952, were not deductible as rental expense, within the meaning of Section 23(a)(1)(A) of the Internal Revenue Code of 1939, *supra*.

Under the statute, a taxpayer is entitled to a "Trade or business expenses" deduction for "rentals * * * required to be made as a condition to the continued use or possession * * * of property to which the taxpayer has not taken or is not taking title *or* in which he has no equity." [Emphasis added.] As this Court expressly pointed out in *Oesterreich* v. *Commissioner*, 226 F. 2d 798, 802, if a taxpayer is "either taking title * * * or has acquired an equity, it cannot treat the payments * * * as rental income" inasmuch as "these two provisions of Sec. 23(a)(1)(A) are stated in the alternative and the deduction cannot be availed of" if the taxpayer "has brought itself into either category prohibited by statute." Consistent with such statutory interpretation the Tax Court, as we shall demonstrate, was here correct in holding, under the entire record (R. 40):

> Clearly, the facts show that petitioner acquired a substantial equity in the sprinkler system by the payment of $1,240 during each of the years 1951 and 1952, which interest is essentially the same that he would have acquired if he had purchased the same sprinkler system under an installment sale contract. The substance of the transaction is not changed by the formal contract provision that legal title remained in Automatic [*Viz.*, the so-called "Lessor".]

In construing a transaction as a sale or a lease, for federal income tax purposes, it is well settled that merely labelling it a "lease" does not control the legal consequences if, in fact, the transaction amounts to a sale. *Oesterreich* v. *Commissioner*, *supra*; *Judson Mills* v. *Commissioner*, 11 T. C. 25; *Taft* v. *Com-*

*missioner*, 27 B.T.A. 808. In determining the proper legal consequences of the transaction, the courts will look to the intention of the parties (R. 35) "as evidenced by the written agreements, read in the light of the attending facts and circumstances existing at the time the agreement was executed." *Haggard* v. *Commissioner*, 241 F. 2d 288 (C.A. 9th); *Benton* v. *Commissioner*, 197 F. 2d 745 (C.A. 5th). As this Court stated in *Oesterreich* v. *Commissioner*, *supra* (pp. 801-802):

> However, the test should not be what the parties call the transaction nor even what they may mistakenly believe to be the name of such transaction. What the parties believe the legal effect of such a transaction to be should be the criterion. If the parties enter into a transaction which they honestly believe to be a lease but which in actuality has all the elements of a contract of sale, it is a contract of sale and not a lease no matter what they call it nor how they treat it on their books. We must look, therefore to the intent of the parties in terms of what they intended to happen.

Accordingly, no merit attaches to the taxpayer's reliance here (Br. 12-22) upon the respective Courts' decisions in the clearly distinguishable circumstances presented in *Benton* v. *Commissioner*, *supra*; *Breece Veneer & Panel Co.* v. *Commissioner*, 232 F. 2d 319 (C.A. 7th); *Abramson* v. *United States*, 13 F. Supp. 677 (S.D. Iowa); and *Haverstick* v. *Commissioner*, 13 G.T.A. 837, or to its attempt (Br. 24) to distinguish *Judson Mills* v. *Commissioner*, *supra*, as a case turning on application of "an arbitrary economic

test." Since the question of the parties intent in a particular case axiomatically constitutes a question of fact, it becomes apparent that none of these factually distinguishable cases can here, in any degree, be regarded as controlling.[2] Principle-wise, however, the proposition is well settled that, regardless of the form of the transaction, so-called "rental" payments must be treated as partial payments on the purchase price of the property involved when, by virtue thereof, the taxpayer acquires, or will acqure, title to, or an equity in the property. *Robinson* v. *Elliot*, 262 F. 2d 383 (C.A. 9th); *Beus* v. *Commissioner*, 261 F. 2d 176 (C.A. 9th); *Quartzite Stone Co.* v. *Commissioner*, 30 T.C. 511.

The facts of this case more than amply support the Tax Court's conclusion (R. 42) that the so-called annual "rental" payments for the installed sprinkler system were not deductible as rental expense. Objectively viewed, they equally compel the conclusion (R. 37-38, 40) that the taxpayer's motive in entering into the "Lease Form of Contract" (R. 13-23) was "obviously to gain the tax benefit of a 'rental' deduction for the annual payments of $1,240", with the "lease" amounting, in substance, to the acquisition, by reason of such payments, of "a substantial equity in the sprinkler system."

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[2] For example, in *Oesterreich* v. *Commissioner*, 226 F. 2d 798, 802-803, where the so-called "lease" agreement called for annual "rental" payments varying from $7,500 to $12,000 and gradually downward again to $7,500, with an option to purchase for $10 after the 68th year, this Court distinguished the *Benton* and *Haverstick* cases, *supra*, by pointing out that "in all of these cases the option price constituted full consideration for the premises or goods acquired."

It is, of course, true that the purported "lease" (R. 13-23) does not contain the customary option to purchase at a fixed price at the conclusion of the specified (R. 13) five-year term. Recitation-wise, paragraph 12 provides "that title to the system and all its component parts and materials shall be and remain indefeasibly vested in "AUTOMATIC" * * * its successors or assigns, and said system shall not be or be deemed to be, a part of or incorporated into the real estate or be deemed to be a fixture." (R. 18.) Paragraph 28 provides that, if taxpayer does not exercise "the privilege of renewing this lease for an additional period of five years at a rental of $32.00 per year", Automatic "is hereby granted the period of six months in which to remove the system from the premises of the LESSEE". (R. 23.) Ambiguously enough, the "lease" is altogether silent as to title, however, in the event that the renewal "privilege" is or is not exercised, with six months elapsing without the "lessor" removing the system from the premises. Clearly, these inconclusive formalistic recitations, coupled with the failure to provide for the ultimate disposition of title in certain altogether forseeable circumstances, make it necessary to examine all of the pertinent "lease" provisions and the here uncontested relevant testimony in order to ascertain the legal effect properly to be accorded the so-called "Lease Form of Contract". Such an examination, we submit, compellingly supports the correctness of the Tax Court's conclusion (R. 40) that the substance of the transaction was to confer on the taxpayer "a substantial equity", arising by reason of the annual

$1,240 installment payments throughout the original five-year term of the purported "lease".

Viewed in their entirety, the record facts more than adequately support the Tax Court's conclusion below (R. 40) that the taxpayer's equity here, "was essentially the same that he would have acquired if he had purchased the same sprinkler system under an installment sales contract." Witness Anderson, the taxpayer's general manager, testified that the taxpayer entered into the so-called "Lease Form of Contract" agreement with Automatic to install the sprinkler system in order to reduce the insurance premiums on the building. (R. 91.) Paragraph 4 of the contract provided that the taxpayer should pay an aggregate "rental" of $6,200 covering a period of five years, payable in annual installments of $1,240 each, beginning May 1, 1950. (R. 14-15.) As indicated above, at the termination of the five year period, the taxpayer was to have the "privilege" of renewing the "lease" for an additional five years at an annual "rental" of $32 per year. (Par. 28, R. 22-23.) Paragraph 10 provided that the taxpayer was to pay all taxes levied against the sprinkler system and maintain insurance on the system, payable to Automatic, in "at least an amount equal to the sum of the total unpaid rentals", with the "risk of loss * * * from any cause whatsoever" falling on the taxpayer. (R. 17.) Paragraph 25 gave Automatic all rights and remedies available to conditional vendors or holders of chattel mortgages in the event any of the provisions of the agreement became void or unenforceable. (R. 21.) Paragraph 23 provided that

Automatic should have the right to assign the "lease" and the "rental installments" as well as the title to the sprinkler system, with the taxpayer waiving any rights to set-off, defense, or counter-claim, as against Automatic's assignee, retaining such rights, however, against Automatic. (R. 21.)

Mr. Carl O. Gustafson and Mrs. Tuttle, the general manager and bookkeeper of Automatic, respectively, testified that the company sold sprinkler systems on both a cash and an installment basis. (R. 111-112, 119-120.) The cash price of a sprinkler system was $4,960 (R. 107), and, when sold under a five year installment contract, it was $1,240 per year, or, as here, under the purported "lease", $6,200 (R. 104-105). Mr. Gustafson testified, further, that the payment of $32 per year for the additional five-year renewal period was a service charge for inspection of the sprinkler system (R. 106-107) with the actual cost of furnishing such annual inspection service amounting to $64 (R. 108-109). Mrs. Tuttle, the bookkeeper, testified that the profit from the so-called "lease" transaction between the taxpayer and Automatic was computed on Automatic's books in the same manner as the profit from a contract installment sale. (R. 118, 119-120.) Mr. Gustafson testified that Automatic (a) had sold, altogether, approximately 1,700 to 1,800 sprinkler systems (R. 115); (b) had "leased" only 25, none of which had ever been removed from a "lessee's" premises and all of which had been "renewed" for inspection purposes (R. 109-110); and (c) had sold, on occasion, under installment terms providing for payment over an

outside period of 15 years, with "about five years" constituting the "average" installment term (R. 111). He testified, further, that the estimated useful life of a sprinkler system was "20 years or more." (R. 110.) On redirect examination, he stated that the "Lease Form of Contract" had been devised by Automatic to stimulate sales. (R. 123.)

Under all of the foregoing established and uncontroverted facts, we submit the Tax Court was more than amply justified in (a) viewing the formal recitation of Automatic's "indefeasibly vested" title (par. 12, R. 18) as "a factor to be considered" but not here controlling on the issue of the deductibility of the payments as rent (R. 37-39); (b) regarding the contract provision requiring Automatic to repair or replace defective or worn-out parts at its own expense (par. 3, R. 14) as "no more than a warranty customarily to be found in contracts of sale" (R. 39); (c) treating the asserted sprinkler installation purpose of reducing insurance rates as immaterial to the sale or "lease" issue, since the result, under a five year installment sales contract calling for identical annual payments would be the same (R. 37-38); and (d) concluding that (R. 40):

> the absence of a specific option to purchase upon payment of a further sum is immaterial where, as here the entire purchase price of the sprinkler system was accounted for in the initial five-year period and the payment of $32 per year thereafter represented a mere service charge for annual inspection of the system.

Moreover, we submit the Tax Court was correct in concluding that the taxpayer's so-called "lease" obligations to (a) pay taxes and insurance (R. 17); (b) grant Automatic all customary conditional vendor rights and remedies (R. 21); and (c) pay annual "lease" installments aggregating the identical $6,200 purchase price offered by Automatic on a five-year installment sales basis (R. 104-105), viewed compositely with the other established facts, indicate (R. 39) "that petitioner acquired a substantial equity in the sprinkler system", with the result that the "rental" payments of $1,240 per year (R. 36) "were intended to be and were in fact partial payments of the purchase price". Even if title has not passed to the "lessee", such "rental" payments may, of course, be treated as capital expenditures where the facts, as here, indicate that the "lessee" is acquiring not merely the right to use the property but a substantial equity in its ownership. *Judson Mills* v. *Commissioner, supra.* As the Tax Court observed, the fact, standing alone, that the annual "rental" payments "dropped off to $32 per year after the first five years" constituted "strong evidence" that the $1,240 annual installment payments made over the initial five year period "were intended as something more than the mere payment for the use of the property. (R. 37-38.) Moreover, the $1,240 payments are, here, substantially greater than either the depreciated or undepreciated value of the sprinkler system,[3] with, as

[3] The Tax Court pointed out (R. 41-42) that, here, the Commissioner has allowed depreciation of $269.60 on the sprinkler system for each of the years 1951 and 1952 (R. 9,

noted above, the aggregate payments during the first five years being equal to the established five year installment conditional sales price. (R. 104-105.) On the other hand, the $32 annual payments after the first five years do not represent (R. 41) "even a token payment on the purchase price of the system" but, instead, are intended to reimburse Automatic for its annual inspection service (R. 106-107). As the Tax Court stated in *Chicago Stoker Corp.* v. *Commissioner*, 14 T.C. 441, 445: [4]

> If payments are large enough to exceed the depreciation and value of the property and thus give the payor an equity in the property, it is less of a distortion of income to regard the payments as purchase price and allow depreciation on the property than to offset the entire payment against the income of one year.

For all the reasons given above, we submit that the Tax Court was correct in holding (R. 42), under all the facts here obtaining, that (a) the installment payments of $1,240 for each of the taxable years 1951 and 1952 were not rental expenses within the meaning

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11). Accordingly, in result, only $970.40 of the 1951 and 1952 annual payments of $1,240 was disallowed as a deduction in each year. Since subsequent depreciation deductions over the remaining useful life of the sprinkler system will be allowable for those years in which only the $32 service charge is payable, the Tax Court observed (R. 42) that "respondent's determination results in a less distorted picture of petitioner's income than if deductions of $1,240 per year are allowed in the first five years of the sprinkler system's useful life."

[4] Cited with approval by this Court in *Oesterreich* v. *Commissioner*, 226 F. 2d 798, 803.

of Section 23(a)(1)(A) of the Internal Revenue Code of 1939; and (b) the Commissioner's determination of additions to tax under Section 294(d)(2) of the 1939 Code (26 U.S.C. 1952 ed., Sec. 294) was correct.

## CONCLUSION

The decision of the Tax Court should be affirmed.

Respectfully submitted,

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